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SBSI - Q2 2016 Southside Bancshares Inc Earnings Call

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CORPORATE PARTICIPANTS

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Lee Gibson *Southside Bancshares, Inc. - President*

Sam Dawson *Southside Bancshares, Inc. - CEO*

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Brady Gailey *KBW - Analyst*

Brady Milsaps *Sandler O'Neill - Analyst*

Kevin Fitzsimmons *Hovde Group - Analyst*

Michael Young *SunTrust Robinson - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Southside Bancshares, Inc. Second Quarter Earnings Call. At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session and instructions will follow at that time. (Operator Instructions) As a reminder, this conference is being recorded.

I would like to introduce your host for today's conference, Ms. Deborah Wilkinson, Executive Vice President, Investor Relations for Southside Bancshares. Ma'am, you may begin.

Deborah Wilkinson - *Southside Bancshares, Inc. - IR*

Thank you, Sylvia. Good morning, everyone and thank you for joining Southside Bancshares Second Quarter 2016 Earnings Call. The purpose for this call is to discuss the Company's results for the quarter just ended and our outlook for upcoming quarters. A transcript of today's call will be posted on Southside.com under Investor Relations.

During today's call and in other disclosures and presentations, I will remind you that any forward-looking statements made are subject to risks and uncertainties. Factors that could materially change our current forward-looking assumptions are described in our earnings release and in our Form 10-K.

Joining me today to review Southside Bancshares second quarter 2016 results are Sam Dawson, our CEO, and Lee Gibson, our President. Our agenda today is as follows -- first, you will hear Lee discuss an overview of financial results for the second quarter of 2016 including loan activity, oil and gas exposure and our loan portfolio, an update on our securities portfolio, and an update on our cost savings. Then Sam will share his comments on the quarter.

I will now turn the call over to Lee.

Lee Gibson - *Southside Bancshares, Inc. - President*

Thank you and good morning, everyone. Welcome to Southside Bancshares 2016 second quarter earnings call. We had a solid second quarter with net income of \$11.4 million. Our diluted earnings per share for the second quarter ended June 30, 2016, were \$0.43 per share, an increase of 2.4% compared to the same period in 2015. Our diluted earnings per share for the six months ended June 30, 2016, were \$0.94, an increase of 22.1% compared to the same period in 2015.



On a linked quarter basis, we reported a \$59 million decrease in loans. This was primarily driven by payoffs in our commercial and construction real estate loan portfolios and the continued rolloff in the indirect auto portfolio of \$12 million. In addition, we charged off \$10.6 million associated with two commercial loans that comprised approximately 62% of our nonperforming loans at March 31, 2016.

Despite the decrease in loan balances during the second quarter, we continue to believe we will experience solid loan growth during the balance of 2016 based on our existing pipeline of approved unfunded loans, the loans we have already booked in July, and loans currently expected to close in the very near future.

At June 30, 2016, our loans with oil and gas industry exposure remain very minimal at 1.2% of our loans. At June 30, 2016, \$5.7 million of our oil and gas industry loans were classified substandard with a 4% reserve. We did not have any oil and gas loans in non-accrual status at quarter-end.

Loan loss provision expense during the second quarter was \$3.8 million, virtually all of which was related to the two large impaired commercial loans that have been charged down to reflect the estimated net selling price of the remaining assets. We currently anticipate cash sales of these assets in excess of \$8 million related to these two loans prior to the end of the third quarter.

During the first half of 2016, nonperforming assets decreased \$8 million, or 24.5% to \$24.5 million, and the ratio of our nonperforming assets to total assets decreased to 0.49% at June 30, 2016, from 0.63% at December 31, 2015.

Next, I'll provide a brief update on our Securities portfolio. At June 30, 2016, we had a net unrealized gain in the Securities portfolio of \$85 million. The duration of the Securities portfolio at June 30th had decreased to 4.52 years compared to the prior quarter's duration of 4.8 years. And the average yield of the Securities portfolio increased 1 basis point on a linked quarter basis.

We anticipate continuing to utilize a barbell approach for our Security purchases using US agency CMOs for the short end and Treasury notes, agency, commercial mortgage-backed Securities and Texas Municipal Securities for the longer end.

During the second quarter, our net interest margin decreased 16 basis points to 3.35%, and our net interest spread decreased 16 basis points to 3.24% on a linked quarter basis. Eleven of the 16 basis points of this decrease were related to the \$1.3 million, one-time interest income in the first quarter associated with a long-time nonaccrual loan payoff. The remaining 5 basis-point decrease in our net interest margin and spread on a linked quarter basis was due to a decrease in the average loan balance and an increase in our cost of funds.

Cost containment efforts came in above expectations during the second quarter. We anticipate cost containment initiatives that we are currently implementing will result in additional cost savings in future quarters.

I will now turn the call over to Sam.

Sam Dawson - *Southside Bancshares, Inc. - CEO*

Thank you, Lee. The second quarter saw earnings improve 2.1% over last year, and six-month earnings jumped 21.3% over the first six months of 2015. The Company showed solid performance by almost any measure primarily due to increasing revenues and improvements in expense control. Net loans were down from year-end, but we experienced basically the same pattern in 2015.

During the second half of 2015, loans exploded, and while we do not expect 11.5% growth of last year, we still anticipate loans will expand into 7% to 9% range for this year. The pipeline is on track. Patience is our watchword. We have been here before.

We continue to experience improvement in our expense control, efforts to improve procedures and streamline our operating processes are now beginning to pay real dividends. Our efforts are not complete, and we'll continue through the remainder of the year as we target our efficiency ratio in the low 50s.



Overall, we are poised for strong performance in the second half of 2016. We believe that loan growth will materialize, and our focus on expense control will continue to provide a positive impact on the bottom line. The fact that the Texas economy has shown resilience coupled with a slight stabilization in oil prices, bodes well for the Company. Our outlook for 2016 is very promising.

At this time, we will conclude our prepared remarks and open the lines for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Brady Gailey, KBW.

Brady Gailey - KBW - Analyst

Could you all just start off and give a little more color on these two nonperforming loans that are going through the foreclosure process -- maybe what they are and what, exactly, is going on there?

Lee Gibson - Southside Bancshares, Inc. - President

One is a loan that we acquired in the merger. The other loan is a loan that's been on nonaccrual for probably a year and a quarter. Both of them matured during the quarter, and we have dealt with them basically through foreclosures, and we are in the process of selling the assets. We have a contract on one of them, and we have a letter of intent on the other one -- the assets. And we anticipate, assuming everything goes as planned that these will sell in August. And this will take care of 62% of the nonperforming loans that were on the books at March, and there really aren't any other major credits that we see at this time, and that was basically the impetus behind the reserve that we had to put out there in the second quarter.

Sam Dawson - Southside Bancshares, Inc. - CEO

Yes, I think that's one of the reasons that we're positive about the second half of the year, Brady. We felt like we've dealt with our problem children. Right now, we see clear sailing. We are anticipating that loan growth that we saw last year. It's a little frustrating that it doesn't come exactly when we want it to, but we know that the fundings will come. A lot of the loans that we've approved have a large equity portion that has to go in before they start to draw, and so we feel like that the second half offers some real potential for us.

Lee Gibson - Southside Bancshares, Inc. - President

I mean, we've already seen close to half of the decrease in the loans in the second quarter have already funded up in July. And then we have a large loan that is supposed to fund on Monday that will put us back almost on track with where we were at 3/31.

Brady Gailey - KBW - Analyst

Okay, okay. So the two loans that are being sold, are those commercial real estate loans or what type of loans were those?

Lee Gibson - Southside Bancshares, Inc. - President

They're both commercial loans.



Brady Gailey - KBW - Analyst

They're both commercial loans, okay. So not necessarily CRE but maybe --

Lee Gibson - Southside Bancshares, Inc. - President

They were not CRE loans. They were both commercial loans, and one of them was an acquired loan, and the other one was a loan that we made several years ago.

Brady Gailey - KBW - Analyst

And they're not energy-related?

Lee Gibson - Southside Bancshares, Inc. - President

They are not energy-related.

Brady Gailey - KBW - Analyst

Okay. And then I'm trying to figure out the math. I think I backed into these two NPLs being around \$13.6 million at the end of March. So you're going to sell them for at least \$8 million. So that leaves a delta of around \$5.6 million, while your net chargeoffs were \$10.6 million? I'm just trying to figure out the difference there.

Lee Gibson - Southside Bancshares, Inc. - President

No, these were around \$20 million if I'm -- is that correct, Julie?

Unidentified Speaker: Yes.

Unidentified Speaker: Yes, one of them was --

Lee Gibson - Southside Bancshares, Inc. - President

-- was around \$13 million, roughly, and the other one was around \$7 million.

Brady Gailey - KBW - Analyst

Okay, okay, okay. All right. And then --

Lee Gibson - Southside Bancshares, Inc. - President

And we had reserves built up on them. One of them -- the one we acquired had, you know, through purchase accounting, had charged down pretty heavily.



Brady Gailey - *KBW - Analyst*

Okay. So as a result of this, the reserve is now 63 basis points?

Lee Gibson - *Southside Bancshares, Inc. - President*

That is correct.

Brady Gailey - *KBW - Analyst*

Which grades a little low. I know you have the OmniAmerican marks still out there, which will push that ratio up. How do you think the reserve trends from here? I mean, do you think we see, kind of, a notable climb back up to 1% over the next few years?

Lee Gibson - *Southside Bancshares, Inc. - President*

You know, with the Omni discount, I think it's up closer to 77, and, you know, we have a little over -- I think it's around \$280 million, or \$292 million of municipal loans out there that we keep a reserve of about 0.25%, because we've never had a loss on any of those. So that brings that reserve down. We have a fairly large one-to-four-family home loan portfolio. That reserve is not sitting at 1%. So when you look at the size of the types of loans that we have out there in the risk profile, it doesn't necessarily generate an overall 1% reserve. But, yes, I mean, eventually, we'll -- the reserve will build back up some. Right now, the reserve, we believe, is adequate.

Brady Gailey - *KBW - Analyst*

Okay, all right, that's helpful. And then last, for me, just -- you were talking about the cost containment effort. Can you maybe just quantify how much cost savings you think will be realized? If you look at the expenses -- the core expenses in the second quarter, I think they were around \$25.1 million. How much lower will you go there?

Lee Gibson - *Southside Bancshares, Inc. - President*

It's tough to say exactly how much lower it's going to go, but there are more things that we're working on there, and some of it is going to happen through attrition, over time. There's additional branch cost control that is going to occur. There are a number of things that are rolling off over the balance of this year. So I think there's room for, probably, another, at least, maybe \$0.5 million a quarter if not maybe a little bit more.

Sam Dawson - *Southside Bancshares, Inc. - CEO*

I think one of the things that we had always said is that we really wanted to see our efficiency ratio maybe in the mid-50s.

Lee Gibson - *Southside Bancshares, Inc. - President*

Right.

Sam Dawson - *Southside Bancshares, Inc. - CEO*

And I think now we have brought it down to the lower 50s, and I think that that certainly is something we've attained and something we should be able to hold. And who knows? It might press even lower. I mean, I don't think we've got anything radical on the line at this point but, again, there are still measures out there that I think will prove fruitful to our bottom line. So --



Lee Gibson - *Southside Bancshares, Inc. - President*

And I'm forgetting the fact that we also had the professional fees associated with the consultants that we won't be paying at that level on a go-forward basis, either. (multiple speakers). So the expenses are going to continue to come down.

Operator

Brady Milsaps, Sandler O'Neill.

Brady Milsaps - *Sandler O'Neill - Analyst*

Hey, Lee, I just wanted to follow up on the larger of the two credits. I had in my notes that -- I know you'd been working with this guy for a while and you'd been trying to keep the business going. You had a fair amount of, I think, marketable securities. I'm just curious to, a, what pushed it this quarter to, kind of, go out and move it out of the bank. And then, two, do you have any prospects of any significant recovery there?

Lee Gibson - *Southside Bancshares, Inc. - President*

Basically, what happened was we started seeing a lot of additional losses in this quarter that he was having that were unusual in nature. And so his projections just weren't coming to fruition, and the losses were significantly greater than what they had been in the past. And so we just decided not to renew and to work out a friendly foreclosure with him and liquidate the assets and sell them. We decided to do that before we ended up with virtually nothing.

Brady Milsaps - *Sandler O'Neill - Analyst*

Got it. So, yes, what we see today, there's not, like, anything else to pursue? It's kind of what we see today?

Lee Gibson - *Southside Bancshares, Inc. - President*

What we see today is where we are. There's really nothing to pursue. He put in several million dollars himself. I forget the exact amount, but he probably put in \$7 million or \$8 million himself, and there really wasn't anything to pursue.

Brady Milsaps - *Sandler O'Neill - Analyst*

Got it, okay, that's helpful.

Lee Gibson - *Southside Bancshares, Inc. - President*

We did have marketable securities, and we've liquidated those.

Brady Milsaps - *Sandler O'Neill - Analyst*

Sure, okay, great. And then maybe just turn to the margin a bit. Can you talk a little bit about what you're seeing there, you know, potential for, you know, obviously, with the long end coming down, what that's going to mean for the NEM? And as you think about any CMO premium amortization -- I know you guys don't buy maybe as many of those, but just kind of curious how you're thinking about the margin over the next couple of quarters?

Lee Gibson - *Southside Bancshares, Inc. - President*

Fortunately, a biggest part of our mortgage-backed Securities portfolio were in the commercial mortgage-backed Securities and locked out of CMOs. So our amortization expense isn't really going to be that volatile, going forward, because the CMBS portfolio is such a huge percentage of the mortgage-backed Securities portfolio. It's probably two-thirds to maybe 75% of that mortgage-backed Securities portfolio. So it's just locked in there, and it's not going to move, and that's what's driven the appreciation in the Securities portfolio and kept the duration where it is.

Brady Milsaps - *Sandler O'Neill - Analyst*

Okay, great. So it really just gets back to if the loan growth does show up, you should get some expansion just from a mix change?

Lee Gibson - *Southside Bancshares, Inc. - President*

That is correct.

Brady Milsaps - *Sandler O'Neill - Analyst*

Okay. And then just, kind of, housekeeping. The tax rate is always a little bit of a moving target. Do you think, kind of, near 20% is kind of where you think you'll be? Or can you work some of your magic to push that lower?

Lee Gibson - *Southside Bancshares, Inc. - President*

It's probably going to be near 20%. We may buy some additional municipals, but I think probably near that 20%. I don't think we're going to push it a whole lot lower. We may get it down to 19%, but it's probably going to be close to that 20%.

Operator

Kevin Fitzsimmons, Hovde Group.

Kevin Fitzsimmons - *Hovde Group - Analyst*

The last few calls, you guys have spoken about being a little more open and on the lookout for M&A opportunities. Could you just give us an update there just in terms of how -- what the pace is of conversations? What the seller pricing expectations? What you think -- how realistic do you think it is that you guys would find something over the balance of this year into early next year?

Lee Gibson - *Southside Bancshares, Inc. - President*

The pace of conversations has definitely picked up. We are definitely hearing from more folks that have an interest. Pricing expectations, it's kind of all over the board. Some people's pricing expectations are unrealistic, others are realistic. Obviously, those that are more what we would consider realistic, the conversations we're more interested in. And so where our currency is and the markets that some of these folks are in, you know, we are actively considering, and there's a possibility if everything makes sense.

Kevin Fitzsimmons - *Hovde Group - Analyst*

And, Lee, by geography, it's still, really, anywhere from Tyler over to Dallas-Fort Worth to Austin -- those are the main focus areas?



Lee Gibson - *Southside Bancshares, Inc. - President*

That would be the main focus area, most definitely.

Kevin Fitzsimmons - *Hovde Group - Analyst*

Okay, great. Just a quick follow-up on fee revenues. Just how we should look at that run rate this quarter about \$8.6 million. I know there was a pretty steep drop in other fee revenues, but that looked, kind of, on the high side last quarter, so if you could address that?

Lee Gibson - *Southside Bancshares, Inc. - President*

We did have -- there was about \$130,000 that we had in fee income -- or it was a gain in the first quarter on one of our investments, CRA investments, that they came back and said that it really wasn't a gain late in the second quarter. So we had to reverse that, so that would have come out of the first quarter, really, and it had to come out in the second quarter. Other than that, it's just things that we had in the first quarter that didn't repeat in the second quarter.

Kevin Fitzsimmons - *Hovde Group - Analyst*

Okay, got it. One last one on it seems to be a growing topic these days. CRE concentration, C&D concentration related to those guidelines from the regulators. You all screen -- have screened above that level on C&D. Just wondering, number one, do you still screen above that? And, number two, is that a relevant issue for you all? Is it something where you feel you need to tap on the brakes a little, or is it simply the regulators come in and check under the hood a little more diligently, and you guys have passed that test?

Lee Gibson - *Southside Bancshares, Inc. - President*

Right now, we screen on construction at that level and just a hair above it. I think we're at 105, 106 -- 105 on construction, but when we run our cash flows, by Christmas, if we didn't approve any more construction, we'd be way below it. So we feel like we can continue to make construction commitments because they typically don't fund for quite some time. The regulators have been in, they have looked under the hood, and as long as we're not planning on going to 150 or something like that, I think they're comfortable. On CRE, we're well below the limits, so there's no issue there.

Operator

Michael Young, SunTrust Robinson.

Michael Young - *SunTrust Robinson - Analyst*

I wanted to ask, you know, you've kind of, as you mentioned, have this, sort of, more seasonal loan growth the last two years, back-end weighted. Do you expect that, going forward again, kind of, next year and into perpetuity? Are you making any adjustments to even that out as we go forward?

Lee Gibson - *Southside Bancshares, Inc. - President*

No. We honestly don't know why that's occurring. It just seems to have occurred. Last year, it all happened in the last four months of the year. It's not something we certainly planned. Once again, it seems to be happening again this year. Hopefully, it's not going to be the last four months. We

have had some good loan growth in July, and it looks like we're going to have some good loan growth in August. So, hopefully, it's the last six months of the year this year. But, no, it's not something we're anticipating is going to be a repeat every year, but I can't guarantee that.

Sam Dawson - *Southside Bancshares, Inc. - CEO*

Yes, we're not planning it that way, by the way. It seems to occur that way, so we can't explain it. And we don't like it much, either.

Lee Gibson - *Southside Bancshares, Inc. - President*

That's not our game plan.

(laughter)

Michael Young - *SunTrust Robinson - Analyst*

That's fair. And then just wanted to see -- are there any areas, given, sort of, the focus on C&D and CRE, understand your concentration levels and where they are. But if maybe C&D were to slow or cool a little bit, are there other areas that you're investing in for growth down the line in terms of hiring or new producers, that sort of thing?

Lee Gibson - *Southside Bancshares, Inc. - President*

We continue to hire lenders of all types that -- because we're not -- our buckets really aren't full anywhere except on the construction side, and the construction side, usually it converts pretty quickly to regular CRE. So we're hiring loan officers that have good books of business that are seasoned, quality loan officers in all of our markets because they're all strong, you know, very healthy, vibrant markets. So we're open for business and looking for strong quality loan officers in all the markets.

Michael Young - *SunTrust Robinson - Analyst*

Okay, great. And just last one, and this may be seasonal in nature, but the non-interest-bearing deposits were down a little bit this quarter. Just curious if any shift there in terms of classifications or with just kind of withdrawals this quarter?

Lee Gibson - *Southside Bancshares, Inc. - President*

That was driven a lot by -- we have some public fund deposits, and there were some dropoffs in some of the public funds deposits, and their fiscal year-ends are usually September 30th. And so it could be driven by their budgetary situations as they come to the close of the year. And I do not know that.

Michael Young - *SunTrust Robinson - Analyst*

So it's not accounts, maybe someone else bidding higher for those public funds. It's just the flow of their --

Lee Gibson - *Southside Bancshares, Inc. - President*

It could be that also because we're not out there trying to bid up on different types of funds. We don't see rates going up anytime soon.



Michael Young - *SunTrust Robinson - Analyst*

Fair enough. You've been right so far. Thanks, guys.

Operator

Brady Gailey, KBW.

Brady Gailey - *KBW - Analyst*

Hey, thanks, I just had one or two more. I think in the past you all have had a little bit of (inaudible) accretion flow through the margin. I was just wondering what that number was in 2Q?

Sam Dawson - *Southside Bancshares, Inc. - CEO*

I'll let Julie --

Unidentified Participant - *Southside Bancshares*

Purchase accretions?

Sam Dawson - *Southside Bancshares, Inc. - CEO*

Are you talking about purchase accretions?

Brady Gailey - *KBW - Analyst*

Yes, just the accretable yield from OmniAmerican that benefits margin. I think it's been running -- maybe it was \$1.2 million last quarter; wondering what that was in 2Q?

Unidentified Participant - *Southside Bancshares*

It was \$1.3 million this quarter, Brady.

Brady Gailey - *KBW - Analyst*

Okay, thanks. And then one more question on these two loans. What cities were they in? I'm guessing the one acquired from OmniAmerican was in Fort Worth. What cities were these loans in?

Lee Gibson - *Southside Bancshares, Inc. - President*

Actually, the one acquired from Omni was, I believe, it was in the outskirts of Dallas in Rockwall. And the one -- the other one was in Houston. It was a car dealer.



Operator

Thank you. (Operator Instructions) At this time, I am showing there are no further participants in the queue. I would like to turn the call back to management for any further remarks.

Sam Dawson - Southside Bancshares, Inc. - CEO

Our asset quality is strong, while loan growth has been late to the party, we still anticipate 7% to 9% loan portfolio growth for 2016. We expect 2016 to be an exceptional year. Thank you for joining us today.

Operator

Ladies and gentlemen, thank you for your participation on today's conference. This concludes your program. You may now disconnect. Everyone have a great day.

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